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**BRIEF ON MERITS**

No. 169

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1960**

POLAROID CORPORATION,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## BRIEF FOR THE PETITIONER

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## BRIEF FOR THE PETITIONER

### Opinions Below

The opinion of the Court of Appeals (R. 59-71) is reported at 278 F(2d) 148 (CA 1st, 1960). The opinion of the Tax Court of the United States (R. 4-16) is reported at 33 TC No. 33 (1959).

### Jurisdiction

The judgment of the Court of Appeals was entered May 3, 1960 (R. 71). The petition for a writ of certiorari was filed June 23, 1960, and was granted October 10, 1960 (R. 72). The jurisdiction of this Court rests on 28 U.S.C. 1952 ed., Section 1254(1).

## Constitutional Provisions, Statute and Regulations Involved

This case involves the following constitutional provisions, statute and regulations:

Article I, Sections 1 and 8 of the Constitution of the United States;

Section 456 of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Section 456); and

Sections 40.456-1(a) and 40.456-2(a) and (b) of Treasury Regulations 130 (1951), as amended, promulgated under the Internal Revenue Code.

Such constitutional provisions, statute and regulations are set forth in the Appendix.[1]

## Questions Presented

1. For the purpose of determining petitioner's abnormal income under Section 456 of the Internal Revenue Code of 1939, did petitioner's income in 1951, 1952 and 1953, respectively, resulting from its revolutionary basic scientific discoveries extending over a period of more than 12 months constitute income from "discovery" within the class of income described in Section 456(a)(2)(B)?

2. If such income was not entitled to be classified as "discovery" income under Section 456(a)(2)(B), was it entitled to classification by the Secretary pursuant to the last sentence of Section 456(a)(2)?

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1. The so-called Korean War Excess Profits Tax Law (added as Subchapter D of Chapter 1 of the Internal Revenue Code of 1939 by the Excess Profits Tax Act of 1950, c. 1199, Title I, sec. 101, 64 Stat. 1137) will be referred to in this brief as the "Korean War Act". The Second World War excess profits tax law (added as Subchapter E, of chapter 2 of the 1939 Code by the Second Revenue Act of 1940, c. 757, Title II, sec. 201, 54 Stat. 974, 975), as amended, will be referred to herein as the "Second World War Act". All references to statutory provisions are to the 1939 Code unless otherwise expressly specified.

## Statement of the Case

Petitioner instituted this proceeding in the Tax Court of the United States for redetermination of deficiencies determined by respondent in petitioner's income and excess profits taxes amounting to $87,935.72, $220,260.07 and $261,682.44 for the years 1951, 1952 and 1953, respectively, and for a review of respondent's disallowance of petitioner's claim for refund of income and excess profits taxes of $193,908.85 for the year 1951 (R. 16-51).

The Tax Court held that petitioner's income from certain basic scientific discoveries hereinafter described did not constitute abnormal income within the meaning of Section 456, and sustained the deficiencies as determined by respondent (R. 4-16).

On appeal, the Court of Appeals for the First Circuit affirmed the decision of the Tax Court on this issue[2] (R. 59-69, 71). The decision below directly conflicts with the decision in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129 (CA 7th, 1960). On October 10, 1960 this Court allowed certiorari in both cases (R. 72, fol. 80).

Petitioner's basic scientific discoveries were (i) the Polaroid Land Process, consisting of the Polaroid Land Camera and the Polaroid Land Picture Roll—a revolutionary photographic system in which by one-step dry processing the developing and printing of the picture take place simultaneously within the camera, enabling the user to obtain a finished dry positive print directly from the

2. The Tax Court also held that interest credited to petitioner on a refund of excess profits tax for the years 1942 and 1943 was to be reduced by interest charged on deficiencies in income tax for those years, in determining petitioner's net abnormal income from "interest" (R. 14-16). The determination of the Tax Court on this issue was reversed by the Court of Appeals and such issue is not involved on this review.

camera within 60 seconds (R. 7, fol. 8), and (ii) the Polaroid 3-D Synthetic Polarizer—a device used in the exhibition of 3-dimensional motion pictures to create the three dimensional illusion (R. 5, fol. 7).

All of the facts were found by the Tax Court, and the only question was the construction of Section 456(a)(2).[3]

Petitioner contended that its income from the Polaroid Land Process and the Polaroid 3-D Synthetic Polarizer fell within the class of income described in subparagraph (B) of Section 456(a)(2),[4] as income resulting from "discovery"; that even if said income were not properly classifiable under this subparagraph (B), the Secretary was obligated to classify it by virtue of the last sentence of paragraph (2)[5]; that the Treasury regulations implementing the last sentence of paragraph (2)[6], should be so construed as to allow such income to constitute a class of income under Section 456(a)(2); and that if not so

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3. Under paragraph (1) of Section 456(a) income is abnormal if it falls within a class under paragraph (2) and in amount exceeds 115% of the average gross income of the same class during the four previous tax years. That petitioner's income from its scientific discoveries during the respective tax years met the mathematical requirement of paragraph (1) was conceded (R. 61, fol. 67). Appendix pp. 1a-2a.

4. "(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months". Appendix p. 2a.

5. "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary". Appendix p. 2a.

6. "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. * * *" (Regulations 130, section 40.456-2(b) (1951). Appendix pp. 7a-8a.

construed, the regulations are invalid as reducing the area of relief provided in the statute.

The Court of Appeals conceded that the Polaroid Land Process and the Polaroid 3-D Synthetic Polarizer were revolutionary discoveries (R. 60, fol. 66), but held that the word "discovery", in subparagraph (B) of Section 456(a)(2), relates solely to the mining industries and does not encompass scientific discoveries, whatever their nature or magnitude (R. 65, fol. 71). The Court of Appeals further held that the last sentence of Section 456(a)(2), while authorizing the Secretary to accept classifications outside the express provisions of subparagraphs (A) to (D), did not obligate the Secretary to do so, and that the Treasury regulations did not establish any class of income in which to place petitioner's income from its scientific discoveries (R. 68-69, fols. 74-76).

The facts, as found by the Tax Court, are as follows:

Petitioner was incorporated in 1937 and from that date to late in 1948 it engaged primarily in the business of manufacturing and selling a variety of optical products in the field of light polarization, such as polarizing sunglasses and visors, polarizing camera filters, polarizing day-driving visors and variable density windows (R. 5, fol. 7).

On February 21, 1947, at a meeting of the Optical Society of America, Dr. Edwin H. Land, petitioner's President and Director of Research, first publicly announced and demonstrated his invention of a camera and photographic film which produced a finished dry positive print directly from the camera within 60 seconds after the picture was snapped. The camera and photographic film are known respectively as the Polaroid Land Camera and Polaroid Land Picture Roll, and together they con-

stitute the Polaroid Land Process.[7] The Optical Society program referred to the Process as "a new kind of photography as revolutionary as the transition from wet plates to daylight-loading film" (R. 7, fols. 8-9).

New basic principles of photographic processing were evolved by Dr. Land in his conception of the Polaroid Land Process. There had never previously existed any photographic process in which a positive print was obtained simultaneously with the development of the negative by the application to the negative and positive receiving sheets of both the silver halide developer and the silver halide solvent. There had been no prior recognition of the possibility of simultaneously introducing the silver halide developer and the silver halide solvent and so controlling their intensities and speed of operation that the developer could perform its function in the presence of the solvent before the solvent could act upon the silver halide in the negative. The four separate steps in the prior art—the developing and fixing of the negative and the printing and fixing of the positive—were compressed in the Polaroid Land Process into one step, the developing and fixing of the negative and contemporaneous formation on a positive sheet of a positive print from the dissolved silver halide of the negative. In the Polaroid Land Picture Roll all materials required for the developing and printing are part of the film assembly. The camera in which the film is processed remains dry throughout (R. 7, fol. 9).

There were at least two major basic developments involved in the Polaroid Land Process. One was a means

7. The Polaroid Land Camera and Polaroid Land Picture Roll together are known to the scientific world and to the trade as the Polaroid Land Process. The Tax Court in its opinion referred to said process as the Polaroid Land equipment (R. 7, fol. 8). In this brief we shall refer to the process as the Polaroid Land Process.

by which high concentrations of developer and silver halide solvents were introduced simultaneously, after having been stored in a capsulating agent to keep them from oxidizing through contact with the air. The second was the process of catalyzing the precipitation of silver from the silver halide solvent onto the surface of the positive receiving sheet in such a way as to obtain a silver image with relatively minute quantities of silver (R. 7-8, fol. 9).

Prior to the conception of the Polaroid Land Process, no photographic process existed whereby the picture was taken, the negative developed, and a positive print obtained directly from the camera by a one step dry process. Dr. Land's new inventions in photographic equipment were novel (R. 8, fol. 10).

Petitioner's first patent in its "Picture in a Minute" field issued in 1948. By the end of 1953, 118 patents had issued and 91 additional applications were pending, and by the end of 1958, 238 patents had issued and 202 additional applications were pending. In 1954, the United States Patent Office created a separate subclass to handle, exclusively, patent applications in the Polaroid Land Process field (R. 8, fol. 10).

The Polaroid Land Process was first marketed by petitioner in November 1948. The camera is not usable with any film other than the Polaroid Land Picture Roll and the picture roll is not usable with any camera other than the Polaroid Land Camera. The photographic accessories marketed by petitioner, such as flash guns, light meters, filters and copymakers, have been specifically designed for the Polaroid Land Camera and have had no market apart from their use with that camera. There have been no products on the market directly competitive with the Polaroid Land Process since its introduction. In addition

to its use in producing a picture in a minute, the Polaroid Land Process is used to make instantaneous X-rays and in devices for the detection of the extent of exposure to radiation (R. 8, fol. 10).

The sales of the Polaroid Land Process during the years 1948 through 1953 resulted entirely from its capacity to produce a picture in a minute. If this Process had not made an instantaneous positive print there would have been no commercial demand for this particular camera or photographic pack during that period (R. 9, fol. 11).

Petitioner's income from the sales of the Polaroid Land Process and photographic accessories during 1948 through 1953 was income from sales of tangible property arising out of research and development which extended over a period of more than 12 months (R. 9, fol. 11).*

In 1952 and 1953, 3-dimensional (3-D) motion pictures were exhibited. The audience viewed the pictures through viewers incorporating the Polaroid 3-D Synthetic Polarizers which were necessary to give the 3-D illusion. Dr. Land invented the synthetic polarizer used in these viewers. Petitioner owned three patents which covered this polarizer. The exhibition of the 3-D motion pictures would not have been commercially practicable had petitioner's synthetic polarizer not been available. No non-infringing material for this purpose was on the market (R. 6, fol. 7).

Petitioner's income from the sale of the 3-D Synthetic Polarizers during the years 1946 through 1953 was income from sales of tangible property arising out of research and development which extended over a period of more than 12 months (R. 6, fol. 8).*

* Paragraph 15 of the Stipulation herein with respect to such work by petitioner over a period of more than 12 months, provides that nothing in said paragraph "shall be construed as in any way limiting petitioner's position that the sole purpose of such work was discovery and that such work culminated in discovery" (R. 56, fol. 62).

By the Stipulation herein (R. 53-58), in the event of a determination in favor of petitioner, counsel have agreed upon the amounts of net abnormal income and the allocation thereof to prior years arising from the Polaroid Land Process and the 3-D Synthetic Polarizer, as follows:

NET ABNORMAL INCOME

| Year | Photo | 3-D |
|---|---|---|
| 1950 | $ 422,419 | $ 3,896 |
| 1951 | 727,120 | 10,538 |
| 1952 | 786,315 | 1,548 |
| 1953 | 1,602,498 | 1,026,934 |
| Total | $3,538,352 | $1,042,916 |

ALLOCATION OF NET ABNORMAL INCOME

| Year | Photo | 3-D |
|---|---|---|
| Prior to 1950 | | |
| 1950 | $ 462,262 | $ 30,773 |
| 1951 | 212,690 | 40,495 |
| 1952 | 231,193 | 90,374 |
| 1953 | 170,306 | 251,613 |

(R. 57-58, fols. 62-63).

## Summary of Argument

1. Petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer, which the courts below conceded to be revolutionary discoveries (R. 13, fol. 15; R. 60, fol. 66), constituted income from "discovery" within the class described in subparagraph (B) of Section 456(a)(2) (Appendix, p. 2a). The word "discovery", as used in that subparagraph, embraces a genuine scientific

discovery creating a new art. Cf. *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129 (CA 7th, 1960). The interpretation that the word relates solely to the mining industries distorts its ordinary and familiar meaning. "Discovery" has been commonly used in judicial opinions and lay writings to describe new contributions in the field of science. The use of "exploration", as well as "discovery", as appropriate to the scientific field, and the context of such words in Section 721(a)(2)(C) of the Second World War Act, from which Section 456(a)(2)(B) is derived, negate the applicability of the doctrine of *noscitur a sociis* in construing subparagraph (B) (*G. D. Searle & Co.* v. *Jarecki, supra*). There is no basis in the legislative history for the premise that such words had become words of art applicable only to the mining industries. Contrary to respondent's contention, Section 337 of the Revenue Act of 1918, which limited the tax rate in certain sales of mines, oil or gas wells, was not the ancestor of Section 456(a)(2)(B). With respect to origin, the relief provisions of Section 456 for abnormalities in income are traceable to Sections 327(d) and 328 of the Revenue Act of 1918, which were applicable to all industries. The omission in subparagraph (B) of the words "research, or development of tangible property", which had appeared in Section 721(a)(2)(C) of the prior law, did not manifest an intent to confine the meaning of "discovery" to its extractive sense. The Congressional purpose for such deletion to plug, "a potential loophole" found to exist in the old law, was completely served by excluding income resulting from research and development that failed to achieve a genuine, significant scientific discovery (*G. D. Searle & Co.* v. *Jarecki, supra*).

2. If such income was not entitled to be classified under subparagraph (B), it was entitled to classification

pursuant to the last sentence of paragraph (2) of Section 456(a), which provided for additional classification by the Secretary of income of "any class" (Appendix p. 2a). The legislative history of this last sentence demonstrates that Congress intended thereby to extend the scope of the section to other types of income which, in the light of the facts present in the taxable year, were as abnormal as the described types. The construction by the Court below that this last sentence gave the Secretary the discretion but not the obligation to provide additional classifications of income, would make the provision invalid as an improper delegation by Congress of its essential legislative functions, in violation of Sections 1 and 8 of Article I of the Constitution.

3. Pursuant to the Treasury regulations issued in implementation of this last sentence of paragraph (2), (Appendix 7a-8a), petitioner properly grouped its income from its basic scientific discoveries in a class similar to the class described in subparagraph (B), as income resulting from what, in the light of the type of business conducted by petitioner, constituted "discovery". If such regulations are to be construed as denying to a taxpayer relief for abnormal income arising from its basic scientific discoveries merely because research or development may have been factors which contributed to the discoveries, the regulations are invalid as reducing the area of relief provided in the statute by the last sentence of paragraph (2). Cf. *G. D. Searle & Co.* v. *Jarecki, supra; Morrill* v. *Jones*, 106 U. S. 466 (1883).

4. The Korean War Act should be construed in the light of its purpose to select, for the imposition of an additional tax, profits which were higher than they probably would have been in the absence of hostilities and the

large military budget (H. R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951—1 Cum. Bull. 187). Petitioner's income from its basic scientific discoveries was not attributable to any stimulus of the war economy. As such, it was the very kind of abnormal income for which Section 456 was designed to afford relief. During the war period in which the statute was enacted, the encouragement of basic scientific discovery was as essential to the nation's interest as the encouragement of the discovery of sources of ores and oils. There is no indication of any Congressional intent to deny to a basic scientific "discovery" the tax relief afforded to the "discovery" of oil and minerals.

## ARGUMENT

### I

### Petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer constituted income from "discovery" within the class of income described in Section 456(a)(2)(B).

The findings of the Tax Court make clear that the new basic principles of photographic processing evolved by Dr. Land in his conception of the Polaroid Land Process created a new art (R. 7-8, fols. 9-10). Prior to the conception of the Process, no photographic process existed whereby the picture was taken, the negative developed, and a positive print obtained directly from the camera by a one step dry process (R. 8, fol. 10). The novelty and scope of this new art are attested by the large number of patents which have been issued in the "Picture in a Minute" field and by the creation by the United States Patent Office of a separate subclass to handle, exclusively, patent applications in such field (R. 8, fol. 10).

The findings also confirm the unique contribution made by Dr. Land to the field of optics by his conception of the 3-D Synthetic Polarizer (R. 5-6, fol. 7).

In its opinion, the Tax Court stated: "For purposes of this case we assume that petitioner's inventions may have been new, startling or even revolutionary" (R. 13, fol. 15); and the following statement appears in the opinion of the Court below: "Taxpayer describes this process as a 'revolutionary discovery'. We shall regard that characterization as accurate" (R. 60, fol. 66).

Dr. Land's conception of the principles embodied in the Polaroid Land Process constituted "discovery" in every sense of the word. The Process has profound significance not only for amateur photography but for fields concerned with the public health and welfare. For the surgeon with a patient on the operating table, the process makes possible the completion of an X-Ray print within one minute, as contrasted with the 20-to-35 minute developing time formerly required (R. 8, fol. 10; Trial Transcript, p. 71). For the worker exposed to the risk of atomic radiation, the Process provides a device for prompt detection of the amount of radiation to which he has been subjected (R. 8, fol. 10; Trial Transcript, p. 72). In the field of wired or wireless communication, the Process provides the means for converting a picture into impulses which may be transmitted over long distances and immediately reproduced on a receiving set (Trial Transcript, p. 73). To those fields and to many others, Dr. Land has brought genuine creativity and the solution of problems that might have remained unsolved for many years but for his discovery of the principles which led to their solution.

Prior to Dr. Land's conception of a sheet polarizer, substances capable of polarizing light were found only in nature (Trial Transcript, p. 83). Because of their high

cost and unwieldy form, these natural polarizers were not suited for commercial adaptation (Trial Transcript, pp. 85, 89-90). Dr. Land's discovery of the scientific principles underlying his invention of the 3-D Synthetic Polarizer made available an application of light polarization not theretofore possible (R. 5-6, fol. 7).

To deny that scientific contributions of this magnitude and novelty constitute "discovery", as that term is used in Section 456(a)(2)(B), is to distort the natural, ordinary and familiar meaning of the term.

It is a cardinal principle of statutory construction that words used in a statute are to be accorded their natural, ordinary and familiar meaning. *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129, 131 (CA 7th, 1960); *Avery* v. *Commissioner of Internal Revenue*, 292 U. S. 210, 214 (1934); *United States* v. *Van Nostrand*, 94 F(2d) 510, 512 (CA 1st, 1938).

Webster's New International Dictionary (Second Edition) defines "discovery" as follows:

> "Discovery: Act, fact, process, or instance of discovering; as: *a* Finding out or ascertaining something previously unknown or unrecognized * * *."

Consistent with this common usage, Article 1 Section 8 of the United States Constitution provides:

> "The Congress shall have Power * * * to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and *Discoveries*." (Italics supplied.)

And Congress since 1790 has used the word "discovery" throughout our statutes pertaining to patentable inventions.[8]

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8. Section 101 of 35 U.S.C. 1952 ed. (c. 950, sec. 101, 66 Stat. 797) provides: "Whoever invents or discovers any new and useful process * * * may obtain a patent therefor". For further instances of the usage together of "invention" and "discovery" in the patent statutes, see the so-called Boykin Act, c. 910, 60 Stat. 940, secs. 2,

In addition, our case law is replete with instances of the use of the word "discovery" by distinguished jurists to describe the contribution made by an invention.

See *Eibel Process Company* v. *Minnesota & Ontario Paper Company*, 261 U. S. 45, 63 (1923) (Chief Justice Taft); *Dolbear* v. *American Bell Telephone Company* (the *Telephone Cases*), 126 U. S. 1, 532, 533 (1887) (Chief Justice Waite); *Harries* v. *Air King Products Co., Inc.*, 183 F(2d) 158, 162 (CA 2nd, 1950) and *Gillman* v. *Stern*, 114 F(2d) 28, 30, (CA 2nd, 1940) cert. den. 311 U. S. 718 (1941) (Judge Learned Hand).

Chief Justice Waite in the *Telephone Cases*, *supra*, stated:

> "Bell discovered that it [the reproduction of speech at a distance] could be done by gradually changing the intensity of a continuous electric current, so as to make it correspond exactly to the changes in the density of the air caused by the sound of the voice. This was his art. He then devised a way in which these changes of intensity could be made and speech actually transmitted. Thus his art was put in a condition for practical use.
>
> In doing this, both discovery and invention, in the popular sense of those terms, were involved: discovery in finding the art, and invention in devising the means of making it useful. For such discoveries and such inventions the law has given the discoverer and inventor the right to a patent—as discoverer, for the useful art, process, method of doing a thing he has found; and as inventor, for the means he has devised to make his discovery one of actual value. * * *" (126 U. S. 1, 532, 533).

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2(a), 2(b), 3 et seq.; the so-called Veterans Patent Extensions Act, c. 444, sec. 1, 64 Stat. 316, as amended by c. 540, 66 Stat. 321; the Tennessee Valley Authority Act, c. 32, sec. 5(i) 48 Stat. 61, 62, 16 U.S.C. 1952 ed. sec. 831d(i); the Mutual Security Act, c. 479, sec. 517, 65 Stat. 382; 22 U.S.C. 1952 ed. sec. 1668; the Atomic Energy Act, c. 1073, secs. 151, 152, 68 Stat. 943, 944, 42 U.S.C. 1952 ed. secs. 2181, 2182; see also the Rules of Practice of U. S. Patent Office, particularly rules 65, 67 and 71.

We respectfully urge that, as used in subparagraph (B) of Section 456(a)(2), the word "discovery" was intended to embrace the genuine discovery of a basic invention creating a new art.

The Court below refused to hold that such a discovery fell within the class described in subparagraph (B), stating that while it agreed "that basic inventions can be described as discoveries, so may any invention, no matter how minor, if it is of sufficient consequence to be entitled to a patent" (R. 63, fol. 69).

The Courts, however, in evaluating the contribution made by patented inventions have distinguished between "genuine discoveries" which have "advanced the art substantially", and "slight improvements". Thus, in *Eibel Process Company* v. *Minnesota & Ontario Paper Company*, 261 U. S. 45, 63 (1923), Chief Justice Taft stated:

> "In administering the patent law the court first looks into the art to find what the real merit of the alleged discovery or invention is, and whether it has advanced the art substantially. If it has done so, then the court is liberal in its construction of the patent, to secure to the inventor the reward he deserves. If what he has done works only a slight step forward, and that which he says is a discovery is on the border line between mere mechanical change and real invention, then his patent, if sustained, will be given a narrow scope, and infringement will be found only in approximate copies of the new device. It is this differing attitude of the courts toward genuine discoveries and slight improvements that reconciles the sometimes apparently conflicting instances of construing specifications and the finding of equivalents in alleged infringements. • • •"

See also *Morley Sewing-Machine Co.* v. *Lancaster*, 129 U. S. 263, 273 (1889), and cases cited therein; *Westing-*

*house* v. *Boyden Power Brake Company*, 170 U. S. 537, 561, 562 (1898).

We submit that the word "discovery" in Section 456(a)(2)(B) should be construed, as applied to the field of science, in the sense of Chief Justice Taft's reference to genuine discoveries which have advanced the art substantially. Such was the meaning ascribed to "discovery" in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129, 131 (CA 7th, 1960). It is with such meaning that lay writers also use the word in referring to scientific discovery.

In an article appearing in the January 1959 issue of Fortune Magazine entitled "The 1960's: A Forecast of the Technology", the following passage appears:

> "The business of science is discovery, and discovery requires penetration of the unknown."

Hans Selye in his article "What Makes Basic Research Basic" gives the following apt description of basic discoveries:

> "To my mind, it is characteristic of great basic discoveries that they possess, to a high degree and simultaneously, three qualities: they are true not merely as facts but also in the way they are interpreted, they are generalizable and they are surprising in the light of what was known at the time of discovery." ("Adventures of the Mind" Alfred A. Knopf, (1959) 135, 139).

The Polaroid Land Process and the 3-D Synthetic Polarizer meet all of these standards of a great basic discovery.

The concern of the Court below that a distinction based on the significance of the discovery would create difficult administrative problems, is unfounded. In the present case, the Tax Court had no difficulty in determining that petitioner's inventions were "new, startling or even revo-

lutionary" (R. 13, fol. 15). The determination as to the significance of a discovery would present no more difficulty than many other determinations in the administration of our tax laws, such as, for example, whether the required percentage of a taxpayer's income during the 36-month period ending on the last day of its base period was attributable to a new product, under Section 443(a) of the Korean War Act[9] (Appendix p. 10a).

The conclusion of the Court below that the word "discovery" as used in subparagraph (B) "relates to the mining industries, and to nothing else" (R. 65, fol. 71) was predicated on an inapposite application of the so-called *noscitur a sociis* doctrine and a misconception of the legislative history of Section 456.

The *noscitur a sociis* principle has no application where there is no ambiguity in the words used.[10] *Russell Motor Car Company* v. *United States*, 261 U. S. 514, 519 (1923).

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9. Regulations 130, section 40.443-2(a) (1951) provides:

> "(a) *Substantial change in products or services.*—(1) For the purpose of section 443, there is a change in products or services only if the new products or services are substantially different from the products or services previously furnished. Ordinarily, it is necessary that the trade custom or practice [is] to treat the new products or services as being of a different class from the products or services previously furnished by the taxpayer. A mere improvement or change in style of product or service does not constitute a change in the product or service. The change must represent more than a usual or customary event in the type of business in which the taxpayer is engaged. In certain types of business it is customary to eliminate unprofitable lines and add new lines as, for example, in a business the products of which are affected by style changes. Such variation in products would not qualify as a change in products furnished. The addition of a new product to a line of varied products, as where a novelty store selling hundreds of items adds several new lines, will not ordinarily be held to constitute the addition of new products for the purpose of section 443. * * *"

10. The presence in Section 456(a)(2)(B) of the phrase "or any combination of the foregoing" shows that each of the words "exploration", "discovery", and "prospecting" was intended to have separate meaning. These words did not compose a unitary phrase,

Of such three words, only the word "prospecting" ordinarily has a restricted geophysical meaning.

Webster's New International Dictionary (Second Edition) defines "explore" as follows:

"To seek for or after; to strive to attain by search".

The same dictionary gives as synonyms of "exploration" the words "search, investigation, probe".

That "exploration" is not confined to exploring for ores or oil is apparent from the common usage of such word in other contexts. Reference is frequently made, for example, to exploration leading to the discovery of new lands, to the exploration of outer space, to the exploration of the atom, and even to exploratory surgical operations.[11]

The common meaning of both "exploration" and "discovery", as applicable to the field of science, is illustrated in the following excerpts from the article by Leonard Engel "A Guide to Understanding What Science is All

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as does "lock, stock and barrel", referred to in the opinion of the Court below (R. 62, fol. 68), which in and of itself has acquired a meaning distinct from that of its component words (Webster's New International Dictionary (Second Edition)).

By restricting these words to mining there would be redundancy. While the words may have shades of different meaning in certain contexts, when applied to mining, as the Court below has stated (R. 63, n. 5), their connotations overlap. In Section 303(a) of the Defense Production Act of 1950 (c. 932, sec. 303, 64 Stat. 801; 50 U.S.C. App., 1952 ed., sec. 2093(a)), which gave the President the power to make provision for the encouragement of "exploration, development, and mining of critical and strategic minerals and metals," the word "exploration" was apparently used as embracing prospecting and discovery. The word "exploration" was similarly used in Sections 433(a)(1)(P) and 450(b)(2) of the Korean War Act. Appendix pp. 9a, 11a.

11. In *Keystone Brass Works* v. *Commissioner of Internal Revenue*, 12 T.C. 618, 626 (1949), a case involving abnormal income under Section 721(a)(2)(C), the Court applied the word "exploration" to an activity of the taxpayer in devising techniques to meet specifications for the manufacture of a product theretofore wholly unknown to it.

About" (New York Times Book Review Section of June 14, 1959, p. 7):

> "• • • science is also a great adventure, whether the object is the *exploration* of space or the *exploration* of the atom, *the digging up of the past* or the pursuit of disease germs • • •."
>
> "An overwhelming majority of recent science books for the general public are 'fact' books relating the *discoveries* of science and how these *discoveries* have been or can be applied to man's needs. • • • Science is not simply an accumulation of research findings; it is also a procedure for pursuing and making new *discoveries*." (Italics supplied.)

Furthermore, the combined single classification in Section 721(a)(2)(C), from which Section 456(a)(2)(B) is derived, of "exploration, discovery, prospecting, research, or development of tangible property, patents, formulae or processes", demonstrates that Congress did not regard the word "exploration" or the word "discovery" or the word "prospecting" as alien to the other income producing factors specified in the same class. The inclusion of the words "exploration", "discovery", "prospecting" with "research, or development of tangible property, patents, formulae, or processes", in describing one and the same class of income, established the intention, as was appropriate in a general tax relief statute, to ascribe a broad connotation to the words "exploration, discovery, or prospecting", applicable to all types of industrial enterprise.[12] These words had the same broad meaning when repeated in Section 456(a)(2)(B).

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12. It would appear that such intention was so understood by the Secretary who, in his Regulations covering Section 721, stated:

> "An item of income resulting from exploration, discovery, prospecting, research or development is all such income for the taxable year arising out of a unit of property, such as an oil lease or other mineral property defined in section

As was stated in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 429, 131 (CA 7th 1960), with respect to the meaning of the word "discovery" in Section 456(a)(2)(B):

> "• • • We do not deem the maxim *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to 'exploration, discovery, or prospecting or any combination of the foregoing.' The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning. • • •
>
> • • • Neither the context of Sec. 456 nor the legislative history demonstrates that the term 'discovery' was intended to describe only the discovery of that which is already in existence *i.e.* natural resources. If Congress had intended to limit the meaning of 'discovery' it would have been a simple matter for it to have expressly done so."

The assertion of the Court below that the legislative history supports a conclusion that prior to the enactment of the Second World War Act the words "exploration", "discovery" and "prospecting" had become words of art applicable only to the mining industries, is predicated solely on Section 337 in Title III "War Profits and Excess Profits Tax" of the Revenue Act of 1918, c. 18 (40 Stat. 1057, 1096), the identical provision in Section 211(b) in the income tax portion of such statute (40 Stat. 1064), and the re-enactment of such sections in later statutes.[13] Such section provided:

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29.23(m)-1(i) of Regulations 111, a patent or a formula • • •" (Regulations 112, sec. 35.721-7 (1944)).

It is noteworthy that in such regulation the income was not stated as resulting from exploration, discovery or prospecting in the case of a unit of property such as an oil lease or other mineral property, and as resulting from research or development in the case of a patent or formula.

13. The sections were repeated in the income tax and excess profits tax titles of the Revenue Act of 1921, c. 136, secs. 211(b),

> "That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 percentum of the selling price of such property or interest."

That the provisions of such section applied only to mines, oil or gas wells is, of course, obvious since the section starts with the words "In the case of a bona fide sale of mines, oil or gas wells". Moreover, the section used the words "exploration and discovery work" and not "exploration" or "discovery". In the clearly expressed context the words used in the section could have no other sense than their meaning as applied to mining.[14]

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337, 42 Stat. 227, 237, 277. The section as applicable to the income tax was carried into the Internal Revenue Code of 1939, c. 2, sec. 105, 53 Stat. 36 (now sec. 632 of the Internal Revenue Code of 1954).

14. The order in which the words appear in Section 456(a)(2)(B), ("exploration, discovery, or prospecting"), also challenges characterization of them as words of art. As applied in their extractive meaning, the natural sequence would have been to place both "prospecting" and "exploration" before "discovery", as was done in Section 337 of the Revenue Act of 1918 quoted in the text. In Rev. Rul. 236, 1953-2 Cum. Bull. 236, it is stated:

> "Exploration or prospecting by a taxpayer begins with the first field work designed to determine whether to acquire or retain the acreage in the area in which a discovery is later made. * * * Exploration is ended and discovery occurs for a pool when a well is completed that proves the presence of oil or gas in commercial quantities * * *."

When Congress has enacted legislation applicable solely to the natural resources industries, it has not left the identification of its intended beneficiaries to inference; in such instances the wording of the statutory provision has made clear, as in Section 337 of the Revenue Act of 1918, that it applied only to the designated industries.

The Court below seemingly accepted as valid respondent's unsupported contention that the derivation of the provisions of subparagraph (B) of Section 456(a)(2) may be traced back to the above-quoted Section 337 (and its income tax counterpart Section 211(b)), of the Revenue Act of 1918 (R. 65-66, fols. 71-72).[15]

This contention involves a misconception of the legislative history. Sections 327(d) and 328 of the Excess Profits Tax Title of the Revenue Act of 1918, which dealt with "abnormal conditions affecting the * * * income of the corporation",[16] and not Section 337, were the pro-

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Compare Sections 433(a)(1)(I), 433(a)(1)(P), 450(a) and (b) and 453(a) and (b) of the Korean War Act (Appendix pp. 8a-9a; 10a-12a; 12a-18a).

15. Respondent's brief in the Court below stated (p. 18):

"Thus, Section 105 of the 1939 Code * * * is virtually identical, even in terminology, with Section 211(b) of the Revenue Act of 1918. Section 456(b)(2)(B) [sic.] of the 1939 Code is the companion excess-profits tax provision, modified in accordance with the altered statutory framework and expanded to cover the gradual sale of the wasting asset."

Were respondent's contention correct that Congress changed the earlier provision so as to give effect to the "gradual sale of the wasting asset", a similar change would have been made in the comparable income tax section, Section 105 of the 1939 Code.

16. Section 327(d) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1093, provided that if the excess profits tax "owing to abnormal conditions affecting the capital or income of the corporation" worked upon such corporation "an exceptional hardship" evidenced by gross disproportion between the tax computed without benefit of such section and the tax computed by reference to the representative corporations as specified in Section 328, the tax should be determined as provided in Section 328. That section provided that the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption) for the taxable year as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption) for such year. (See Appendix, pp. 24a-26a.) These sections were repeated in the Revenue Act of 1921, c. 136, secs. 327, 328, 42 Stat. 227, 275, 276.

genitors of the relief provisions of the Second World War Act and the Korean War Act for abnormal income. These were general sections, applicable to qualifying corporations in all industries. The placing of income into separate classes for the purpose of determining abnormality, and the description of the class from which the class described in subparagraph (B) of Section 456(a)(2) is derived, were first made in Section 721 of the Second World War Act. There is no basis in the legislative history to support respondent's bare contention that the class of income described in subparagraph (B) of Section 456(a)(2) is a modified version of Section 337 of the Revenue Act of 1918.

The Court below also erred in concluding that the omission from subparagraph (B) of the words "research, or development of tangible property", and the grouping in subparagraph (C), as a separate class, of income resulting from "the sale of patents, formulae or processes," manifest an intent to confine the meaning of the word "discovery" to its extractive sense.

By taking out "research, or development of tangible property", Congress did not thereby exclude "invention", for the word "research" is not synonymous with "invention".

In *United States* v. *Dubilier Condenser Corporation*, 49 F(2d) 306 (D. Del. 1931); aff'd 59 F(2d) 381 (CA 3rd, 1932); aff'd 289 U. S. 178 (1933), "research" was carefully distinguished from "invention":

> "• • • 'Research' has been defined as the 'endeavor to discover, to develop, and to verify knowledge', and 'careful or critical inquiry or examination in seeking facts or principles'. *While invention may and usually does presuppose research, research certainly does not usually involve or result in invention. To say that a person engaged in 'research' work is necessarily engaged in 'inventive work' is putting an unwarranted construction upon the word*

*'research', not justified by common knowledge or experience."* (49 F(2d) 306, 312; italics supplied).[17]

The House and Senate Committee reports[18] stated that the purpose of the deletion of "research, or development of tangible property" was to plug "a potential loophole of major dimensions" found to exist in the old law. No reason exists for concluding that Congress intended such deletion to effect any greater change than was necessary to accomplish its stated purpose. Such purpose was completely served by excluding income resulting from research and development that failed to achieve a genuine discovery which substantially advanced the art.[19]

The only need from the administrative point of view was to exclude income resulting from research and development where the inability to relate such income directly to the research or development could create the potential loophole. In the case of the discovery of a new basic invention no such potential loophole could exist, since the income derived therefrom is directly and necessarily related to such discovery.[20]

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17. The opinion of the Court of Appeals in the cited case stated: "* * * We find nothing in the record or in the common meaning of the two words to suggest this identity * * *" (59 F. (2d) 381, 385).

18. H.R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951-1 Cum. Bull. 187, 195; Senate Rep. No. 2679, 81st Cong., 2d Sess., December 18, 1950, 1951-1 Cum. Bull. 240, 249.

19. So construed, the change in the law affected the major area of research in industry—the area connected with changes in style, design, model or product and with normal mechanical improvements in process or products, none of which involves invention in the order of discovery.

20. The Tax Court found that petitioner's income from the Polaroid Land Process resulted entirely from its capacity to produce a picture in a minute, and that absent such capacity there would have been no income from such source whatsoever (R. 9, fol. 11). The Tax Court further found that the exhibition of 3-D motion pictures would not have been commercially practicable had petitioner's synthetic polarizer not been available, and that no non-infringing material for this purpose was on the market (R. 5-6, fol. 7).

This proper interpretation of the Congressional intent was made by the Court of Appeals for the Seventh Circuit in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129, 131 (CA 7th 1960).

The only effect of the change in classification of income resulting from the sale of patents, formulae or processes was to alter the standard for the determination of abnormality. For that purpose under the prior law, such income had been grouped with other income in the same statutory class. Under Section 456(a)(2)(C), the abnormality was determinable by reference to the income from that source alone. There is no statement in any Committee report which supports the conclusion of the Court below that the grouping of this income as a separate class of income under subparagraph (C) was intended to affect the meaning of the word "discovery" in subparagraph (B). Had Congress any such intent, the likelihood is that it would have said so in its Committee reports.

The opinion of the Court below adverts to the substitution in the sections of the Korean War Act dealing with relief for abnormalities occurring during the base period, of a more automatic approach for the discretionary approach of Section 722 of the Second World War Act.[21] This substitution has no bearing on the method provided by the statutes for relief for abnormalities in income during the taxable year. As expressly stated in paragraph (e) of Section 456, the section has no effect upon the computation of base period net income. Moreover, the provisions of paragraphs (b), (c) and (d), which define the method for attribution of net abnormal income to other years and for computation of the tax, if net abnormal income is found to exist under paragraph (a), manifest no change of approach, since the provisions of such para-

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21. R. 64, footnote 7.

graphs, except for inconsequential word changes, are identical to the comparable paragraphs of Section 721.[22]

We respectfully submit that petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer falls squarely within the class of income described in Section 456(a)(2)(B) as income resulting from "discovery".

## II

**If petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer was not entitled to be classified as "discovery" income under subparagraph (B) of Section 456(a)(2), such income was entitled to classification by the Secretary pursuant to the last sentence of Section 456(a)(2).**

The last sentence of Section 456(a)(2) reads as follows:

> "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

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22. The changes made with respect to abnormalities in the base period in Sections 442-447 of the Korean War Act from the provisions of Section 722 of the Second World War Act were in the method of computing the relief and not in the factors of qualification for such relief. All but one of the qualifying factors under Section 722 were qualifying factors under the Korean War Act provisions. See Senate Rep. No. 2679, 81st Cong., 2d Sess., December 18, 1950, 1951-1 Cum. Bull. 240 at 252; H.R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951-1 Cum. Bull. 187 at 198.

The standardized treatment provided in Section 721 for computing the relief for abnormalities in income during the taxable year made such relief automatic (*United States* v. *Koppers Co.*, 348 U. S. 254, 267 (1955); *American Coast Line, Inc.* v. *Commissioner of Internal Revenue*, 159 F(2d) 665, 667 (CA 2d 1947); *Pohatcong Hosiery Mills, Inc.* v. *Commissioner of Internal Revenue*, 162 F(2d) 146, 148 (CA 3rd 1947)).

Such provision, we submit, required the Secretary to classify petitioner's income from its basic scientific discoveries.

The legislative history of this last sentence demonstrates that Congress intended thereby to extend the scope of the section to other types of income, which, in the context of the facts which might exist in the taxable year, were as abnormal as the described types.

As originally enacted, Section 721(a)(2) of the Second World War Act provided relief only with respect to six specifically enumerated classes.[23] In the Excess Profits Tax Amendments of 1941[24], the provision was broadened by the addition of the sentence: "The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary." The reason for such amendment was stated as follows:

> "Section 721 of the present law provides relief with respect to certain abnormalities in income in the taxable period. These abnormalities, six in number, are specifically described * * *. It is believed advisable to extend the principle of this section to any abnormal item of income. As the types of abnormal income that may occur cannot be predicted in advance, adequate relief can only be granted by thus extending the scope of this section." (H.R. Rep. No. 146, 77th Cong., 1st Sess., "Excess Profits Tax Amendments of 1941", 1941-1 Cum. Bull. 550, 55[illegible]

This provision for classification of other classes of income was carried over into Section 456(a)(2) in vir-

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23. Senate Rep. No. 2114, 66th Cong., 3d Sess., September 11, 1940, 1940-2 Cum. Bull. 528, 533.

24. Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, 22.

tually the same language, but only after Congress had deliberated again as to the advisability of restricting abnormal income to the classes expressly defined, and of recognizing no other type of income as abnormal.

The Korean War Act originated in the House of Representatives as H.R. 9827. Section 454(A)(2) of that bill set forth the classes of income described in paragraph (2) of Section 456(a), as finally enacted, including the last sentence providing for additional classifications by the Secretary. The Senate Finance Committee proposed an amendment (Amendment No. 201) to strike out this final sentence. In conference, however, the Senate receded and agreed to the wording initially used in the House bill (H.R. Rep. No. 3231, Conference Report, 81st Cong., 2nd Sess., December 22, 1950, 1951-1 Cum. Bull. 268, 277).[25]

The determination of the Court below that the provisions of the last sentence of Section 456(a)(2) gave the Secretary the discretion but not the obligation to provide additional classifications of income, not only ignores the deliberate intention of Congress, manifest from the legislative history, of extending the scope of the section, but also raises grave doubts as to its constitutionality. So construed, this provision would constitute an improper delegation by Congress of its essential legislative functions in violation of Article I, Sections 1 and 8 of the

25. The summary of H.R. 9827 as agreed to by the Conferees, prepared by the staff of the Joint Committee, added as item 5 to a numerical listing of the four classes described in subparagraph (A)-(D) of Section 456(a)(2) "income of other classes permitted under regulations prescribed by the Secretary". (Summary of H.R. 9827, "The Excess Profits Tax Act of 1950 as Agreed to by the Conferees, prepared by the Joint Committee on Internal Revenue Taxation, December 1950, p. 9.)

Constitution, for nowhere in the statute are there any standards, express or implied, for determining which additional classes of income the Secretary may elect to classify or refuse to classify. *Panama Refining Co.* v. *Ryan,* 293 U. S. 388, 421, 428, 429, 434 (1935).

The words "any class" in this provision of the statute establish that the Secretary was under a mandate to classify all income and that only the designation of the class in which a particular type of income was to be placed was left to the Secretary's discretion.[26] So construed, there would be no question as to its constitutionality. *United States ex rel. Attorney General* v. *Delaware & Hudson Company,* 213 U. S. 366, 407 (1909); *Knights Templars' and Masons' Life Indemnity Company* v. *Jarman,* 187 U. S. 197, 205 (1902).

In discharge of his administrative duty, the Secretary issued regulations to the effect that if a taxpayer had income which did not fit into one of the four classes enumerated in the statute, the taxpayer should group such income in such class similar to one of the specified classes as was reasonable in a business of the type conducted by it and as was appropriate in the light of its business experience and accounting practice (Regulations 130, Section 40.456-2(b) (1951) Appendix pp. 7a-8a). Pursuant to this instruction, petitioner grouped its income from the Polaroid Land Process and the 3-D Synthetic Polarizer in a class similar to the class set forth in subparagraph (B)

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26. In Rabkin & Johnson, Excess Profits Tax (Matthew Bender & Co. 1957) Section 81.05, it is stated with respect to what is excluded under Section 466 from the impact of the excess profits tax:

> "* * * The inclusion of the quoted sentence in the final statute indicates clearly that any 'class' of income which qualifies under the statutory formula may be excluded, even though it does not fall within one of the designated classes."

of Section 456(a)(2), as income resulting from what, in the context of the type of business conducted by petitioner, constituted "discovery".

The determination of the Court below that "If 'discovery' relates to mining and natural resources, taxpayer's classification is not 'similar'" (R. 69, fol. 75), involves a misunderstanding of what the regulation requires to be similar. A difference in the type of business is assumed; only the source of income must be "similar" in the light of taxpayer's type of business.

We further submit that the Court below erred in concluding that the regulations specifically state that income of this class is not subject to relief (R. 69, fols. 75-76).

Regulations 130, Section 40.456-2(b) (1951) provides:

> "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

It is apparent from the first word of the third sentence of the regulations—"However"—that the third sentence must be read as a qualification of the second sentence. The third sentence[27] clearly states that Section 456 is applicable to "such income" (i.e. the income resulting from the sale of tangible property arising out of research and development, which is the subject matter of the second sentence), if the income is otherwise properly includible within a class of income to which such section is applicable (i.e. the classes specifically described in the statute and the additional classes provided for in the first sentence of the regulation).[28]

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27. The third sentence was added to the regulations by the Treasury Department for the express purpose of making clear that there was no intention to exclude, under certain circumstances, income from the sale of tangible property arising out of research and development.

As originally proposed and published in the Federal Register on December 4, 1952 (17 F.R. 10973), the regulation provided:

> "Income from the sale of tangible property, however, even though such income may arise out of research and development which has extended over a period of more than 12 months is not income to which section 456 is applicable. Such income from the sale of tangible property may not constitute or be included in any class of income for purposes of section 456(b)."

This proposed regulation was abandoned in favor of the one finally adopted, which, in the added third sentence, recognized that income from the sale of tangible property arising out of research and development falls within Section 456 if the income is otherwise properly includible within a class of income to which such section is applicable (T.D. 6026, 1953-2 Cum. Bull. 235).

28. The provision in the first sentence making taxpayer's grouping of income subject to the approval of the Commissioner on the examination of taxpayer's return, gave the Commissioner the authority to review whether the grouping of such income into a particular class was proper. To construe this provision as giving any greater authority to the Commissioner would make it invalid for the reasons set forth in the text.

Under this proper interpretation of the regulation, we submit, even if the word "discovery" in subparagraph (B) of Section 456(a)(2) were limited to the discoveries of the mining industries, petitioner's income from its basic scientific discoveries was properly grouped in a class similar to the class set forth in subparagraph (B). We further submit that if the regulation is to be construed as denying to a taxpayer relief from abnormal income resulting from its basic scientific discoveries merely because research or development may have been factors which contributed to the discoveries, such regulation must be rejected as invalid as reducing the area of relief provided in the statute by the last sentence of subparagraph (2) of Section 456(a). Compare *G. D. Searle & Co.* v. *Jarecki*, 283 F(2d) 129, 131 (CA 7th 1960); *Morrill* v. *Jones*, 106 U. S. 466 (1883).

## III

**The conclusion that petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer constitutes abnormal income under Section 456 is confirmed by the purpose underlying the Korean War Act.**

The purpose of the Korean War Act was to tax the additional profits resulting from the wartime economy.

As was stated in House of Representatives Report No. 3142, 81st Congress, 2nd Session (1950) (1951-1 Cum. Bull. at p. 187):

> "One of the main objectives in imposing an excess profits tax is to reach corporate profits which have been swollen by the increased tempo of the economy. An excess profits tax selects for additional tax those

> corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget * * *".

The purpose of the relief provisions in such a law with respect to abnormal income is to exempt abnormal income arising solely from a corporation's internal achievements and not from the stimulus of the war economy.[29] *Soabar Company* v. *Commissioner*, 7 TC 89, 96 (1946).

Petitioner's profits during the tax years were not "higher than they probably would have been in the absence of hostilities and a large military budget". Its income from the Polaroid Land Process and the 3-D Synthetic Polarizer was not the additional income which the Korean War Act was designed to reach. On the contrary, its income from the Polaroid Land Process resulting, as found by the Tax Court, "entirely from its capacity to produce a picture in a minute" (R. 9 fol. 11), and its income from the 3-D Synthetic Polarizer arising, as found by the Tax Court, entirely from its capacity to create, in the exhibition of 3-D motion pictures, the illusion of the three dimensions, which could not have been accomplished without it (R. 5-6, fol. 7), were not attributable to any stimulus of the war economy. Abnormal income from such sources constituted the very kind of abnormal income for which Section 456 was designed to afford relief.

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29. In the formulation of our excess profits tax laws since the enactment of the first such law to meet the emergencies of the First World War, the purpose of Congress to achieve an equitable distribution of the additional tax burden has been as compelling as its aim to provide adequate revenue. H.R. Rep. No. 767, 65th Cong., 2d Sess. "Revenue Bill and Report", Document No. 1267, p. 2, September 3, 1918; H.R. Rep. No. 146, 77th Cong., 1st Sess., "Excess Profits Tax Amendments of 1941", p. 2, February 27, 1941, 1941-1 Cum. Bull. 550; H.R. Rep. No. 3142, 81st Cong., 2d Sess., "Excess Profits Tax Act of 1950", 1951-1 Cum. Bull. 187, 188.

That a statute is to be construed in the light of its purpose is a well recognized rule of statutory construction. *Central Bank* v. *United States*, 345 U. S. 639, 646 (1953); *United States* v. *Sullivan*, 332 U. S. 689, 693 (1948).

We respectfully urge that to interpret the word "discovery" in subparagraph (B) of Section 456(a)(2) as confined only to the extractive industries, and to deny to income resulting from basic scientific discoveries classification under the broad provisions of the last sentence of paragraph (2), as the Court below has done, ignores the purposes of the Korean War Act and of its relief provision for abnormal income. Such interpretation penalizes enterprises which have encouraged their most talented and resourceful people to discover breakthrough inventions. Such interpretation saddles these enterprises with an additional tax burden simply because of the fortuity that the discoveries came to fruition in an excess profits tax year. In this era, when the encouragement of scientific discoveries is of vital importance to the nation's well-being, when the need for attracting and inspiring the nation's gifted youth to scientific endeavor is one of the major concerns of our government, when the survival of our civil, political and economic way of life may depend upon building strength through invention, the efforts and achievements of our scientists are among our major natural resources. During the war period in which the statute was enacted, the encouragement of basic scientific discovery was at least as essential to the nation's interests as the encouragement of the discovery of sources of ores and oils. In that context, it is difficult to conceive that Congress intended to deny to a basic scientific "discovery" the tax relief afforded to the "discovery" of oil and minerals.

## CONCLUSION

**For the reasons stated, it is respectfully submitted that the judgment of the Court below should be reversed and the case remanded to the Tax Court for the fixing of petitioner's net abnormal income and the attribution thereof to prior years, in accordance with the Stipulation herein.**

Dated: December 2, 1960.

Respectfully submitted,

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JULIUS SILVER.

# APPENDIX

## United States Constitution

Article 1 Section 1:

All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

Article 1 Section 8:

The Congress shall have Power • • •

To promote the Progress of Science and useful Arts, by securing for Limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries; • • •

To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

## STATUTE INVOLVED

### Section 456 of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed., Section 456)

SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.* For the purposes of this section—

(1) *Abnormal income.* The term 'abnormal income' means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally

derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.* Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

(3) *Net abnormal income.* The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average

amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount attributable to other years.* The amount of the net abnormal income that is attributable to any previous or future taxable year or years, shall be determined under regulations prescribed by the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income for a previous taxable year.

(c) *Computation of tax for current taxable year.* The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (com-

puted under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of tax for future taxable year.* The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year; and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1) (B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1) (B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable year. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of section.* This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c) and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d)."

## TREASURY REGULATIONS INVOLVED

"Reg. 130, Sec. 40.456-1. *Abnormalities in income in taxable year.*—(a) Section 456 applies if abnormal income (as defined in section 456(a)) for any excess profits tax taxable year is attributable to other taxable years. The term 'abnormal income' means income of any class de-

scribed in section 40.456-2 includible in the gross income of the taxpayer for any excess profits tax taxable year (1) if it is abnormal for the taxpayer to derive gross income of such class, or (2) if the taxpayer normally derives gross income of such class but the amount of such income of such class is in excess of 115 percent of the average amount of the gross income of the same class determined for the four previous taxable years or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence. It is abnormal for a taxpayer to derive income of any class only if the taxpayer had no gross income of that class for the four previous taxable years. For the purpose of determining abnormal income under this paragraph the gross income of the class for the previous taxable years is not to be increased or decreased by any allocation under the provisions of section 456. Abnormal income is to be determined by considering classes of income, and not merely particular items."

(b) • • •.

"Reg. 130, Sec. 40.456-2. *Classification of income.* (a) Section 456(a) (2) (A), (B), (C), and (D) sets forth four separate classes of income. All the income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456-3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b) (9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a) (2), to which section 456 is applicable may be grouped by the taxpayer,

subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

## OTHER STATUTORY REFERENCES

**Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.)**

SEC. 433. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Ending After June 30, 1950.*—The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13(a)(2), for such year increased or decreased by the following adjustments:

(1) *Adjustments.*—

* * *

(I) *Non-taxable income of certain industries with depletable resources.*—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 453, there shall be excluded non-taxable income from exempt excess

output of mines and timber blocks provided in section 453; in the case of a natural gas company, as defined in section 453, there shall be excluded nontaxable income from exempt excess output provided in section 453; and in the case of a producer of minerals, or a producer of logs or lumber from a timber block, there shall be excluded nontaxable bonus income provided in section 453. In respect to nontaxable bonus income provided in section 453(c), a corporation described in section 453(c)(2) shall be deemed a producer of minerals for the purposes of this subparagraph;

• • •

(P) *Payments to encourage exploration, development and mining for defense purposes.*—An amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, and the forgiveness or discharge of any such amount, shall be excluded in computing excess profits net income; and any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but upon the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increase in basis shall to the extent of such repayment be allowed as if made at the time of such repayment;

• • •

SEC. 443. AVERAGE BASE PERIOD NET INCOME —CHANGE IN PRODUCTS OR SERVICES.

(a) *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes with respect to any taxable year that—

(1) During so much of its three immediately preceding taxable years as falls within the 36-month period ending on the last day of its base period, there was a substantial change in the products or services furnished by the taxpayer,

(2) More than 40 per centum of its gross income or 33 per centum of its net income for such taxable year is attributable to one or more of the new products or services, and

(3) Its average monthly excess profits net income (determined under subsection (e)) for such taxable year exceeds 125 per centum of its average monthly excess profits net income (determined under subsection (e)) for the taxable years ending within its base period and prior to the taxable year in which the first change to which gross income is attributed for the purpose of this subsection occurred,

then, in computing its excess profits credit for taxable years under this subchapter which end on or after the last day of the earliest taxable year with respect to which the requirements of paragraphs (1), (2), and (3) are satisfied, its average base period net income determined under this section shall be the amount computed under subsection (b).

• • •

SEC. 450. CORPORATIONS ENGAGED IN MINING OF STRATEGIC MINERALS.

(a) *Exemption from tax.* In the case of any domestic corporation engaged in the mining of a strategic mineral,

the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income.

(b) *Definitions.* For the purposes of this section—

(1) the term "strategic mineral" means antimony, chromite, bauxite, manganese, nickel, platinum (including the platinum group metals), quicksilver, sheet mica, tantalum, tin, tungsten vanadium, fluorspar, flake graphite, perlite, long-fibre asbestos in the form of amosite, chrysotile or crocidolite, beryl, cobalt, columbite, corundum, diamonds, kyanite (if equivalent in grade to Indian kyanite), molybdenum, monazite, quartz crystals, and uranium, and any other mineral which the certifying agency has certified to the Secretary as being essential to the defense effort of the United States and as not having been normally produced in appreciable quantities within the United States.

(2) The term "certifying agency" means the department, official, corporation, or agency utilized or created to carry out the authority of the President under section 303(a) of the Defense Production Act of 1950 to make provision for the encouragement of exploration, development, and mining of critical and strategic minerals and metals.

(c) *Certification during taxable year of taxpayer.* In determining under subsection (a) the portion of the adjusted excess profits net income which is attributable to the mining of a mineral which is a strategic mineral by reason of a certification made during the taxable year, such

portion shall be an amount which bears the same ratio to the portion of the adjusted excess profits net income, determined without regard to this subsection, attributable to such mining during the entire taxable year as the number of days for which the taxpayer held the mineral property during the taxable year and after the date of the making of the certification bears to the number of days for which the taxpayer held the property during such taxable year.

(d) *Application of section to lessor.* In the case of a mining property operated under a lease, income attributable to such property derived by a lessor corporation shall, for the purposes of this section, be considered to be income of a corporation engaged in mining.

SEC. 453. NONTAXABLE INCOME FROM CERTAIN MINING AND TIMBER OPERATIONS, AND FROM NATURAL GAS PROPERTIES.

(a) *Definitions.* For the purposes of this section and section 433(a)—

(1) *Producer; lessor; natural gas company.* The term "producer" means a corporation which extracts minerals from a mineral property, or which cuts logs from a timber block, in which an economic interest is owned by such corporation. The term "lessor" means a corporation which owns an economic interest in a mineral property or a timber block, and is paid in accordance with the number of mineral units or timber units recovered therefrom by the person to which such property or block is leased. The term "natural gas company" means a corporation engaged in the withdrawal, or transportation by pipe line, of natural gas.

(2) *Mineral unit, natural gas unit, and timber unit.* The term "mineral unit" means a unit of

metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property. The term "natural gas unit" means a unit of natural gas sold by a natural gas company. The term "timber unit" means a unit of timber recovered from the operation of a timber block.

(3) *Excess output.* The term "excess output" means the excess of the mineral units, natural gas units, or timber units for the taxable year over the normal output.

(4) *Normal output.* The term "normal output" means the average annual mineral units, or the average annual timber units, as the case may be, recovered in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950, (hereinafter in this section called "normal period"), of the person owning the mineral property or the timber block, (whether or not the taxpayer). The term "normal output", in the case of a natural gas company, means the average annual natural gas units sold in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950, (hereinafter in this section called "normal period"), of the person owning the natural gas property (whether or not the taxpayer). The average annual mineral units, natural gas units, or timber units shall be computed by dividing the aggregate of such mineral units, natural gas units, or timber units for the normal period by the number of months for which the mineral property, natural gas property, or timber block was in operation during the normal period and by multiplying the amount so ascertained by twelve. In any case in which the taxpayer establishes, under regulations prescribed by the Secretary, that the operation of any mineral property, natural gas property, or timber block is normally prevented for a specified period each year by physical events outside the

control of the taxpayer, the number of months during which such mineral property, natural gas property, or timber block is regularly in operation during a taxable year shall be used in computing the average annual mineral units, natural gas units, or timber units, instead of twelve. Any mineral property, natural gas property, or timber block, which was in operation for less than six months during the normal period, shall, for the purposes of this section, be deemed not to have been in operation during the normal period.

(5) *Natural gas property.* The term "natural gas property" means the property of a natural gas company used for the withdrawal, storage, and transportation by pipe line, of natural gas, excluding any part of such property which is an emergency facility under section 124A.

(6) *Mineral property.* The term "mineral property" means a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction.

(7) *Minerals.* The term "minerals" means ores of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, shell, silica, slate, soapstone, soda, sulphur, and talc.

(8) *Timber block.* The term "timber block" means an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture.

(9) *Normal unit profit.* The term "normal unit profit" means the average profit for the normal

period per mineral unit for such period, determined by dividing the net income with respect to minerals recovered from the mineral property (computed with the allowance for depletion computed in accordance with the basis for depletion applicable to the current taxable year) during the normal period by the number of mineral units recovered from the mineral property during the normal period.

(10) *Alternative computation.* In any case in which more than one mineral property is owned or operated by a lessor or producer as defined in (a) (1) of this section, such lessor or producer may treat the mineral properties as one property for purposes of computing exempt excess output under this section.

(11) *Estimated recoverable units.* The term "estimated recoverable units" means the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property at the end of the taxable year plus the excess output for such year. All estimates shall be subject to the approval of the Secretary, the determinations of whom for the purposes of this section, shall be final and conclusive.

(12) *Exempt excess output.* The term "exempt excess output" for any taxable year means a number of units equal to the following percentages of the excess output for such year:

100 per centum if the excess output exceeds 50 per centum of the estimated recoverable units;

95 per centum if the excess output exceeds 33-1/3 but not 50 per centum of the estimated recoverable units;

90 per centum if the excess output exceeds 25 but not 33-1/3 per centum of the estimated recoverable units;

85 per centum if the excess output exceeds 20 but not 25 per centum of the estimated recoverable units;

80 per centum if the excess output exceeds 16-2/3 but not 20 per centum of the estimated recoverable units;

60 per centum if the excess output exceeds 14-2/7 but not 16-2/3 per centum of the estimated recoverable units;

40 per centum if the excess output exceeds 12-1/2 but not 14-2/7 per centum of the estimated recoverable units;

30 per centum if the excess output exceeds 10 but not 12-1/2 per centum of the estimated recoverable units;

20 per centum if the excess output exceeds 5 but not 10 per centum of the estimated recoverable units.

(13) *Unit net income.* The term "unit net income" means the amount ascertained by dividing the net income (computed with the allowance for depletion) from the coal, ore, sulphur, potash, metallurgical grade limestone, chemical grade limestone, or timber recovered from the mineral property, or timber block, as the case may be, during the taxable year by the number of units of such mineral or timber recovered from such property in such year. In respect of a natural gas property, the term "unit net income" means the amount ascertained by dividing the net income, computed in accordance with regulations prescribed by the Secretary, from such property during the taxable year by the number of natural gas units sold in such year.

(b) *Nontaxable income from exempt excess output.*

(1) *General rule.* For any taxable year for which the excess output of mineral property which was in operation during the normal period exceeds 5 per

centum of the estimated recoverable units from such property, the nontaxable income from exempt excess output for such year shall be an amount equal to the exempt excess output for such year multiplied by the normal unit profit, but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the excess output for such year.

(2) *Mines in operation during normal period.* For any taxable year, the nontaxable income from exempt excess output of a metal or coal mining property, or of a sulphur, potash, metallurgical grade limestone, or chemical grade limestone mineral property, which was in operation during the normal period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year, or an amount determined under paragraph (1), whichever the taxpayer elects in accordance with regulations prescribed by the Secretary.

(3) *Timber properties.* For any taxable year, the nontaxable income from exempt excess output of a timber block which was in operation during the normal period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year.

(4) *Certain properties not in operation during normal period.* For any taxable year, the nontaxable income from exempt excess output of a metal or coal mining property, of a sulphur, potash, metallurgical grade limestone, or chemical grade limestone mineral property, of a timber block, or of a natural gas property, which was not in operation during the normal period, shall be an amount equal to one-third of the net income for such taxable year (computed with the allowance for depletion) from

such property or timber block, as the case may be. For the purposes of the preceding sentence, a metal mining property shall be deemed not to have been in operation during the normal period if, during the period it was in production during 1946, 1947, 1948, and 1949, the aggregate gross income derived therefrom was less than the aggregate of the deductions (allowed under section 23 without regard to any net operating loss deduction) attributable to such property during such period of production.

(5) *Natural gas companies.* In the case of a natural gas company any of the natural gas property of which was in operation during the normal period, the nontaxable income from exempt excess output for any taxable year shall be an amount equal to the excess output for such year multiplied by one-half of the unit net income for such year.

(c) *Nontaxable bonus income.* The term "nontaxable bonus income" means the amount of the income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of:

(1) A mineral product or timber, the exhaustion of which gives rise to an allowance for depletion under section 23 (m), but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the output in excess of such quota; or

(2) A mineral product extracted or recovered from mine tailings by a corporation which owns no economic interest in the mineral property from which the ore containing such tailings was mined, but such amount shall not exceed the net income attributable to the output in excess of such quota.

(d) *Rule in case income from excess output includes bonus payment.* In any case in which the income attribut-

able to the excess output includes bonus payments (as provided in subsection (c)), the taxpayer may elect, under regulations prescribed by the Secretary, to receive either the benefits of subsection (b) or subsection (c) with respect to such income as is attributable to excess output above the specified quota.

SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months;[1] or

1. Subparagraph (B) of Section 721(a)(2) was made inapplicable to taxable years beginning after December 31, 1941, by Section 222(f) of the Revenue Act of 1942, which Act, by Section 222(d), added Section 736 to the Code to provide relief for taxpayers with income from long-term contracts.

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

(3) *Net abnormal income.*—The term "net abnormal income" means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income of a previous taxable year.

(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of Tax for Future Taxable Year.*—The amount of the net abnormal income attributable to

any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year, and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in

the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1)(B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (4)(B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable years. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Commissioner with the approval of the Secretary, the tax

under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

(f) *Abnormal Income From Exploration, etc.*—If, by reason of taking into account, in determining constructive average base period net income under section 722, exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, such constructive average base period net income is higher than it would be without such taking into account, only such portion of the income in the taxable year resulting from such activity which is of a class described in subsection (a)(2)(C) as is attributable to another taxable year under this subchapter shall be deemed attributable to a year other than the taxable year.

**Revenue Act of 1918, c. 18, 40 Stat. 1057, 1093**

SEC. 327. That in the following cases the tax shall be determined as provided in section 328.

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 percentum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917 and November 11, 1918, both dates inclusive.

Sec. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for

such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 percentum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 percentum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 percentum of the net income. In any case the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 percentum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 percentum per month on such excess from the time the instalment was due.

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